

DISSERTATION PROPOSAL

Yi Liang

“An Economic Inquiry of Audit Market and Regulation”

Thursday, March 26, 2015

9:00 am

324 GSIA (West Wing)

My proposed dissertation empirically evaluates the economic impact of mandatory auditor rotation using both reduced form and structural estimation.

In the first chapter, I provide an extensive industry background and literature review to motivate my dissertation. I will first review the industry background and then focus on reviewing theoretical and empirical literature on three streams: (1) papers directly related to mandatory auditor rotation, (2) papers related to audit market industrial organization and dynamics, and (3) papers on the corporate governance role of auditing and its interaction with corporate governance. I also propose to provide a discussion about the benefit and cost of using structural estimation in auditing research.

In the second chapter, I examine the impact of mandatory auditor rotation by providing evidence using regressions. Prior literature documents that longer auditor-client relationship (i.e., auditor tenure) improves audit quality; this chapter extends the existing literature by taking the length of auditor-manager personal relationship into account when evaluating mandatory auditor rotation. My preliminary result suggests that longer personal relationship also improves audit quality even after controlling auditor tenure. This result highlights that mandatory auditor rotation can be even more costly than previously thought because the valuable personal relationship is also eliminated after the rotation. I propose to provide additional evidence about this result and study (a) how the improved audit quality from personal relationship is affected by other factors such as firm existing internal governance; (b) whether the improved audit quality from personal relationship persists even after managers leave the firms; and (c) if the manager moves to another firm, whether the improved audit quality from personal relationship will also carry over to the new firms when the new firm and the old firm share the same auditor.

In the third chapter, I empirically evaluate and quantify the economic impact of mandatory audit firm rotation using a structural approach, focusing on the critical role played by firm existing internal governance. My counterfactual analysis suggests that (1) mandatory audit firm rotation can reduce US public firm shareholder lifetime value from auditing by 2.05 percent to 15.54 percent on average; (2) a significant fraction of the reduction results from reduced board effectiveness in selecting desirable auditors and hence the policy is more costly to the shareholders of the firms with strong internal governance; (3) policies that improve firm internal governance can work better and increase shareholder value; and (4) mandatory rotation becomes even more costly and further increases the cost of reduced board effectiveness by approximately 4.0 percent when firm internal governance improves and the board interests become fully aligned with shareholder interests. These findings highlight the unintended cost of mandatory audit firm rotation and that the proposed rotation may counteract other policies intended to improve internal corporate governance. I propose to extend the work by (a) investigating the situation where the clients' cost of switching varies over time, (b) providing more reduced form evidence about auditor-client matching, and (c) estimating a more comprehensive model.